

SPLIT INTEREST VALUATION: THE DEVIL IS IN THE DETAIL

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I. BACKGROUND

With respect to valuation, the estate and gift tax provisions of the Internal Revenue Code (I.R.C.) operate under similar principles. In order to determine taxable estate, a taxpayer must first determine gross estate and subtract any authorized exemptions and deductions.¹ In determining taxable gifts in a given year, a taxpayer may reduce the total value of the gifts which were made during the year by any authorized exclusions and deductions.² The focus of these materials will be on how certain assets are valued for purposes determining the estate and gift tax liability. Specifically, the discussion will focus on valuation of annuities, life, term and remainder or reversionary interests.

For federal estate tax purposes, valuation principles are generally governed by I.R.C. §§ 2031 through 2044 and the regulations there under.³ While the I.R.C. is silent as to specific valuation methods, the estate tax regulations fill in the detail.⁴ The gift tax code and regulations conform to and adopt the approach taken by the estate tax regulations.⁵

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¹ Treas. Reg. § 20.0-2(b)(2)-(3) (as amended in 1992).

² Treas. Reg. §§ 25.2503-1 to -2 (as amended in 1995).

³ Treas. Reg. § 20.0-2(b)(2).

⁴ See, e.g., Treas. Reg. §§ 20.2031-1 to -8 (as amended in 2000).

⁵ See RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 10.02[2][a] (8th ed. 2002).

Each item of property included in a decedent's gross estate is valued at the time of decedent's death.⁶ The fair market value of an item of property included in gross estate is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having a reasonable knowledge of relevant facts."⁷ The regulations under I.R.C. § 2031 contain substantial guidance on application of this standard. For example, specific rules and methods apply to valuation of stocks, notes, bonds, interests in a business, and household personal effects.⁸ The same valuation standards apply when assets are gifted during life.⁹

Complications, however, arise when an asset that is transferred is split into more than one interest. For example, if a donor seeks to gift or bequest an annuity for life, income interest for life, or a corresponding remainder interest, the value of each is dependent upon an estimation of the remaining years of life of the life interest holder.¹⁰ Valuation of such "partial" or "split" interests in a single asset requires knowledge of the lifespan of the relevant interest holder or the specific term which the interest will be held. The closest that we can come to determining the length of a human lifespan is an actuarial determination or estimation of the lifespan of the relevant individual.¹¹ Without assistance from the Internal Revenue Service (IRS) or the U.S. Department of the Treasury (Treasury), taxpayers imposed upon by the I.R.C. to value a partial interest in property for a person's life must engage a professional actuary to perform a statistical calculation of risk or life expectancy for valuation purposes. However, requiring such a valuation in every instance of a gift would be expensive, inefficient, and time consuming.

Not surprisingly, legal analysis in this area of taxation requires a substantial amount of calculations to compare different scenarios over time. Although the calculations involve actuarial tables and use of interest

⁶ Treas. Reg. § 20.2031-1(b). Note, however, that under I.R.C. § 2032, a decedent's estate may elect to use an alternative valuation date which, if elected, allows assets to be valued six months after decedent's date of death. I.R.C. § 2032(a) (2006).

⁷ Treas. Reg. § 20.2031-1(b).

⁸ See, e.g., *id.* §§ 20.2031-1 to -6.

⁹ See Treas. Reg. § 25.2512-1 (as amended in 1992).

¹⁰ See Treas. Reg. § 20.2031-7(a) (as amended in 2000).

¹¹ See *id.* § 20.2031-7(d).

rates, the mathematics are not complex. The reader is encouraged to take it at his or her own speed. While the calculations are not taxing, the outcomes of certain structures or scenarios can be.

II. ACTUARIAL VALUATION

For estate and gift tax purposes, the fair market value of various types of partial or split interests in annuities, life estates, terms of years, remainders and reversionary interests is the present value of such interests as of the date of transfer.¹² The Treasury has published actuarial tables that may be used by taxpayers to determine the value of partial interests in property.¹³ Without the published tables, taxpayers would have to engage a valuation professional in every instance in which a split interest gift required valuation. While the IRS actuarial publications contain hundreds of pages of tables, the regulations under I.R.C. § 2031 contain several of the more commonly used tables.¹⁴

An example helps to explain the application of the IRS tables in valuing a simple partial interest in a gift tax setting. Assume that Brother transfers \$1,000,000 to his Sister and her Son in trust. The trust terms provide that Sister, or her estate, will receive all income produced by the trust property for a period of five years. Upon expiration of the five-year term, the trustee of the trust is required to distribute the corpus of the trust to Sister's Son. At all times the corpus is worth \$1,000,000 and the I.R.C. § 7520 interest rate is eight percent (the Applicable Federal Rate or AFR).¹⁵ For gift tax purposes, the questions are what value is assigned to the term interest given to Sister and what is the value of the remainder interest given to Sister's Son?

The elements necessary for the calculation are:

¹² See *id.* § 20.2031-7(a).

¹³ See *id.* § 20.2031-7(d)(6).

¹⁴ See *id.* § 20.2031-7(d); see also INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, ACTUARIAL VALUATIONS (2009), available at <http://www.irs.gov/pub/irs-pdf/p1457.pdf>; Internal Revenue Serv., Dep't of the Treasury, Section 7520 Actuarial Tables, <http://www.irs.gov/retirement/article/0,,id=206601,00.html> (last visited Aug. 11, 2009).

¹⁵ In general, the value of any annuity, life interest, term of years, or remainder must be valued under the tables provided by the Secretary of the IRS and by using the interest rate equal to 120 percent of the Federal midterm rate in effect under I.R.C. § 1274(d) for the month in which the valuation date falls. I.R.C. § 7520(a) (2006).

- Term of the income interest: five years
- The Table B,¹⁶ five-year term certain **remainder factor** at eight percent rate = .680583¹⁷
- Five-year **term factor** = $1 - .680583^{18} = 0.319417^{19}$

Applying the factors we determine the value of the five-year term income interest to be \$319,417 ($0.319417 \times \$1,000,000$). Thus, \$319,417 is the present value of Sister's five-year term interest. Correspondingly, \$680,583 ($\$1,000,000 \times .680583$) is the present value of Sister's Son's interest in the remainder after five years. The two amounts must be reported as taxable gifts by Brother. From this it can be seen that Brother has "split" his ownership of the \$1,000,000 contributed to the trust into two separate interests, Sister's present interest in the income stream from the trust and Sister's Son's future interest in the assets at the end of the five-year term.

Following with a similar but different example, assume the same facts as above except that the trust instrument provides that Sister is to annually receive only the first \$40,000 income each year. If the AFR is eight percent, additional income will accrue to the trust each year in excess of the trust's obligation to distribute only \$40,000 per year. The additional income must be added to the corpus and Sister's interest is more in the nature of an annuity (as opposed to an income interest as discussed above). In order to determine the value of Sister's five-year annuity interest, a calculation is necessary, which includes the following elements:

- Term of the annuity: five years
- Table B eight percent annuity factor: 3.9927²⁰

¹⁶ Table B contains the actuarial factors for valuing the remainder interest in property after a term certain interest has expired. Treas. Reg. § 20.2031-7(d)(6).

¹⁷ Reference must be made to Table B to cross reference the five-year term with the 8% interest rate to obtain this factor. *Id.*

¹⁸ Note that this is the remainder factor and that the term factor plus the remainder factor added together equal "1" or the "whole."

¹⁹ Note here that the full value of the undivided asset is \$1,000,000. The value of the term interest plus the remaining interest added together must equal the whole or \$1,000,000. Thus, the term factor is arrived at by subtracting the remainder factor from one.

²⁰ The annuity factor can be arrived at via the following formula: $1/i[1-1/(1+i)^n]$. See, e.g., NetMBA, Annuities, <http://www.netmba.com/finance/time-value/annuity> (last visited (continued)

- Annual payment: \$40,000

Applying the factors, we determine that the present value of the \$40,000 annuity for five years to be \$159,708 ($\$40,000 \times 3.9927$). The present value of the remainder interest must necessarily be \$840,292 ($\$1,000,000 - \$159,708$).

What are the benefits of gifting partial interests? Historically, taxpayers sought to “freeze” the value of an asset within their estates by setting up a trust and retaining a modicum of control over the contributed property. Taxpayers commonly split the ownership of an asset by placing the asset in trust and retaining a life interest while giving the remainder interest to grantor’s child. The taxpayer grantor would benefit by (1) maintaining use and control over the asset during his or her life, (2) “freezing” the value of the remainder by making a current irrevocable gift of the remainder to taxpayer’s child, and (3) avoiding payment of estate tax on any future appreciation that might occur.²¹ By making an irrevocable gift of the remainder interest, a grantor could pay gift tax based on the value of the assets at the time of contribution of the asset into trust thus “freezing” the value.²² By paying gift tax, if any, on the transfer of the remainder interest in an asset, the grantor could avoid inclusion in gross estate of any appreciation in the asset experienced between the date of creation of the trust and the grantor’s death.²³

In its current form, I.R.C. § 2036 provides that gross estate includes the value of all property to the extent of any interest that a decedent had previously transferred (by trust or otherwise) and retained a right for his life or any other period of time.²⁴ Congress’ goal was to place an impediment in front of taxpayers who sought to freeze future appreciation value out of their estates by transferring assets to descendants while retaining a lifetime interest in the same asset.²⁵ But following the

August 13, 2009) (containing an excellent mathematical discussion on how to arrive at the present value annuity factors). This formula will be used for other examples in this article.

²¹ See STEPHENS ET AL., *supra* note 5, ¶ 19.02[1][a].

²² See *id.*

²³ See *id.*

²⁴ I.R.C. § 2036(a) (2006).

²⁵ See STEPHENS ET AL., *supra* note 5, ¶ 19.01[1].

enactment of I.R.C. § 2036, there were complaints that the provisions were too broad and vague in application.²⁶

A. I.R.C. § 2702

In 1990, Congress sought to refine and limit taxpayers ability to engage in estate freeze techniques by replacing portions of I.R.C. § 2036 with Chapter 14 of the I.R.C.²⁷ Chapter 14 consists of several sections that operate independently from § 2036 to prevent taxpayers from engaging in various types of estate freezes.²⁸ Chapter 14 contains valuation rules that apply to (1) transfers of corporate and partnership interests to specific family members, (2) transfers of interests in trusts to certain family members, and (3) transfers of property subject to certain agreements, such as buy-sell agreements.²⁹ Sections 2701 and 2702 of Chapter 14 determine the gift tax consequences at the time of a transfer of any of these assets.³⁰

The requirements of § 2702 only apply where a specific familial relationship exists between the grantor of the trust and the trust beneficiary.³¹ Specifically, § 2702(a) applies to transfers of an interest in property to a trust for the benefit of a member of the transferor's family.³² A "member of the family" is defined as the transferor's spouse, a lineal descendant of either the transferor or the transferor's spouse, any brother or sister of the transferor, and the spouse of any such descendant.³³ The rule also targets transfers between a grantor and a member of the family wherein an "applicable family member" (other than the grantor) retains an interest in the trust.³⁴ An applicable family member is defined as the transferor's spouse, an ancestor of the transferor or of the transferor's spouse, and the spouse of such ancestor.³⁵ If none of these familial relationships exist, the grantor's contribution to the trust is not subject to the special valuation rules and restrictions of § 2702.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ See I.R.C. §§ 2701–2703 (2006); see also I.R.S. Notice PS-92-90, 1991-1 C.B. 998.

³⁰ I.R.S. Notice PS-92-90, 1991-1 C.B. 998.

³¹ *Id.*

³² I.R.C. § 2702(a)(1).

³³ *Id.* §§ 2702(e), 2704(c)(2).

³⁴ *Id.* § 2702(a)(1).

³⁵ *Id.* § 2701(e)(2).

If one or more of the targeted familial relationships exist, § 2702 provides that the amount of the gift is the value of the transferred property less the value of any qualified interest retained by the transferor.³⁶ Said otherwise, where a grantor of a trust retains an interest that is not a qualified interest, the value of the grantor's retained interest is deemed to be zero.³⁷ Assume, for example, that a grantor forms a trust and retains a life income interest in the property contributed to the trust and transfers the remainder in the trust to his child. Under § 2702, if the interest retained by the grantor is not a qualified interest, it is deemed to have no value. This, in turn results in the child's remainder interest being deemed to have a value equal to the full fair market value of the trust property on the date of the gift. In this fashion, the grantor of a trust may not take advantage of the IRS actuarial tables to determine a "partial" value of the remainder interest. Of course, if the interest is a partial interest, use of the tables allows the grantor to avoid some or all of any gift taxes that might be imposed on the transfer by attributing only a partial value to the remainder interest.

While I.R.C. § 2702 may appear to limit a taxpayer's ability to benefit from an attempt to "freeze" the value of assets contributed to a trust, there are several ways in which a taxpayer may plan within the rules of § 2702. For example, if the trust is a charitable remainder trust including a charitable remainder annuity trust (CRAT),³⁸ a charitable remainder unitrust (CRUT),³⁹ or a grantor retained trust including a grantor retained annuity trust (GRAT),⁴⁰ grantor retained unitrust (GRUT),⁴¹ grantor retained income trust (GRIT),⁴² or qualified personal residence trusts

³⁶ See discussion *infra* at footnotes 37–58 and accompanying text defining "qualified interest."

³⁷ I.R.C. § 2702(a)(2)(A).

³⁸ See *id.* § 664(d)(1).

³⁹ See *id.* § 664(d)(2)–(3).

⁴⁰ See *id.* § 2702(b)(1); Treas. Reg. § 25.2702-3(b) (as amended in 2005); 34 AM. JUR. 2D *Federal Taxation* ¶ 40204 (2009).

⁴¹ See I.R.C. § 2702(b)(2); Treas. Reg. § 25.2702-3(c); 34 AM. JUR. 2D *Federal Taxation* ¶ 40204.

⁴² See Treas. Reg. § 20.2036-1(c)(2)(i) (as amended in 2008); see also KATHRYN G. HENKEL, *ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS* ¶ 24.03 (1997).

(QPRT),⁴³ the grantor may nevertheless engage in a type of freeze thereby reducing gift tax on the transfer.

With respect to retained interests, the grantor must retain a “qualified interest” in the trust. Again, retention of a qualified interest allows the grantor to use the IRS actuarial tables for determining value of his or her retained interest in the trust. GRITs do not require a qualified interest. In general, a GRIT is used where the remainder beneficiary is not a member of the grantor’s family as contemplated by the rules.⁴⁴ Because of the relationship (or lack thereof) between the grantor and the remainder beneficiary, a grantor of a GRIT need not retain a qualified interest. In addition to grantor retained trusts and charitable remainder trusts, planners often use private annuities to obtain the benefit of the IRS actuarial tables.⁴⁵

This article will focus on the tax aspects of the GRAT. Additionally, there will also be a discussion on the tax aspects of the private annuity. Each of these instruments shares the common goal of obtaining the benefit of using the actuarial tables to arrive at a positive value for the retained interest which thereby reduces the value of the gift of the remainder interest. Yet, under certain economic or other circumstances, each of these instruments may at times yield large windfalls to the taxpayers that allow avoidance of substantial gift and estate taxes.

B. Structure of a GRAT

The goal of formation of a GRAT is to avoid application of the rule that treats the donor’s retained interest as having no value and to obtain the benefit of using the actuarial tables under the regulations. It is important to note that I.R.C. § 2702 has no application to a transfer that does not result in a complete gift. A GRAT is a product of the federal estate and gift tax code and the following discussion outlines the requirements of a GRAT.

1. Formation

Formation of a GRAT consists of three participants including a grantor (who is also the annuitant), a trustee, and a remainder beneficiary. In general, the grantor contributes property to a trust and retains the right to

⁴³ See Treas. Reg. § 25.2702-5(c) (as amended in 1997).

⁴⁴ HENKEL, *supra* note 42, ¶ 24.03[1], [3].

⁴⁵ See *id.* ¶ 23.01[2].

receive a specified annuity amount for a term of years.⁴⁶ At the end of the term of years, the trust assets will be distributed to the remainder beneficiary.⁴⁷ In order for the transfer to qualify under I.R.C. § 2702 for use of the tables and avoid the retained annuity from being treated as having no value, a number of requirements under the I.R.C. must be met. Grantors must be aware of these requirements while making decisions on whether to implement a GRAT.

2. Requirements

In order to benefit from the use of the tables, as indicated in the previous discussion, a grantor's interest in the GRAT must be a "qualified interest."⁴⁸ A grantor's interest in a GRAT is a qualified interest if it meets a list of requirements provided under the regulations.

3. Contributions by Grantor

A grantor may transfer as much or as little value in property as he or she desires into the trust. In order for the assets to be removed from the grantor's estate, a completed gift must occur. The transfer into trust will not qualify as a completed gift if the grantor retains control of the assets. As such, the trust must be an irrevocable trust.⁴⁹ A grantor may not make any additional contributions to the GRAT after the initial formation.⁵⁰ If the grantor has additional assets that he or she wants to be placed in a GRAT, the grantor should consider creating an entirely new GRAT to be funded with the additional assets.

4. Annuity Payment

The annuity may be expressed as a fixed amount.⁵¹ This could be either a stated dollar amount or a fraction or percentage of the initial fair market value of the asset.⁵² The amount does not have to be the same every year. It can be in graduated payments. However, graduated payments cannot be more than 120 percent greater than the payment of the

⁴⁶ *Id.* ¶ 22.02[1].

⁴⁷ *Id.*

⁴⁸ Treas. Reg. § 25.2702-3(a) (as amended in 2005).

⁴⁹ *Id.* § 25.2702-3(b)(1)(i).

⁵⁰ *Id.* § 25.2702-3(b)(5).

⁵¹ *Id.* § 25.2702-3(b)(1)(ii); *see also* HENKEL, *supra* note 42, ¶ 22.03[2][b].

⁵² Treas. Reg. § 25-2702-3(b)(1)(ii)(A)–(B).

preceding year.⁵³ The trustee of the GRAT may make distributions to the grantor in an amount greater than the annuity payment, but the right to receive such a distribution is not a qualified interest and will not have any effect on the gift made at the outset.⁵⁴ However, additional payments generally are not consistent with the purpose of the GRAT because unqualified distributions to the grantor will tend to increase the grantor's estate and reduce the amount that the remainder beneficiaries will receive.⁵⁵

The GRAT must make at a minimum one payment every year.⁵⁶ If the grantor chooses, he or she may receive an annuity payment more frequently, such as semi-annually or monthly.⁵⁷ If a more frequent payment is received, the annuity payment must be prorated to reflect the frequency of the payments.⁵⁸

The trust terms must fix the number of years that the annuity must be paid.⁵⁹ The term of the annuity paid to the grantor must be fixed upon the creation of the trust.⁶⁰ Selection of a time period has multiple considerations. This is because part or all of the trust property will be included in the grantor's gross estate if he or she dies before the end of the term.⁶¹ One of the main considerations in structuring a GRAT is to choose a term of years that the grantor will retain an interest.⁶² The grantor must outlive the term or some or all of the assets that remain in the trust at the grantor's death must be included in his estate.⁶³ A shorter period of time increases the likelihood that the grantor will outlive the term and avoid inclusion of the assets in grantor's estate. On the other hand, the longer the term is, the less value that will be attributed to the remainder interest.⁶⁴ However, the longer the term is, the less likely it is that the grantor will

⁵³ See HENKEL, *supra* note 42, ¶ 22.03[2][b].

⁵⁴ Treas. Reg. § 25.2702-3(b)(1)(iii).

⁵⁵ See HENKEL, *supra* note 42, ¶ 22.03[2][d].

⁵⁶ Treas. Reg. § 25.2702-3(b)(1)(i).

⁵⁷ Treas. Reg. § 25.2702-3(b)(3).

⁵⁸ *Id.*

⁵⁹ *Id.* § 25.2702-3(d)(4).

⁶⁰ *Id.*

⁶¹ I.R.C. § 2036(a) (2006).

⁶² See HENKEL, *supra* note 42, ¶ 22.03[5].

⁶³ *Id.*

⁶⁴ *Id.*; see also I.R.C. § 2036(a).

outlive the term causing inclusion of some or all of the assets in the grantor's estate.⁶⁵

But the analysis does not end here. While it is true that choosing a shorter time period will increase the likelihood that the assets will not be included in the grantor's estate, a shorter term will also increase the value of the gifted remainder interest. This is because the shorter the term, the smaller will be the present value of the grantor's retained annuity interest. The lower the value that is assigned to the grantor's annuity interest, the higher will be the value of the gifted remainder interest. Remember the two added together equal the whole. Of course, the value of the remainder determines the amount of gift tax due on contribution. In a nutshell, increasing the length of the annuity term increases the value of the grantor's retained interest and reduces the value of the remainder interest. Reduction of the remainder value will reduce the gift tax, if any, that is due.

The term of the annuity is fixed and to the extent that the grantor outlives the term, the grantor will no longer have an interest in the GRAT assets and, therefore, the remaining assets will not be included in his or her gross estate. If the terms of the GRAT instrument allow the trustee to commute or prepay the grantor's retained annuity interest, a trustee could under many circumstances avoid inclusion of the value of the assets upon an early death. For example, if a grantor became terminally ill, he or she may attempt to prepay or accelerate future annuity payments prior to his or her death in an effort to terminate his or her interest and keep the value of the GRAT corpus from being included in his estate. However, the regulations specifically provide that the GRAT document must prohibit commutation of the annuity interest holder.⁶⁶

III. GIFT TAX CONSEQUENCES ON FORMATION

Another example reveals some of the gift tax benefits of forming a GRAT. Assume Taxpayer owns all of the equity of stock of a closely held family entity. The basis of Taxpayer's shares is \$10,000 and the fair market value is \$1,000,000. The value of Taxpayer's equity interest is expected to increase at fifteen percent per year. Taxpayer is married to Wife, and has three adult children.

⁶⁵ See HENKEL, *supra* note 42, ¶¶ 22.02[2], 22.03[5].

⁶⁶ Treas. Reg. § 25.2702-3(d)(5) (as amended in 2005).

Assume Taxpayer contributes all \$1,000,000 of his shares to a GRAT and that he is age sixty-three when he makes the transfer. The GRAT terms provide that Taxpayer will receive \$50,000 per year. If Taxpayer dies prior to the expiration of the annuity term, the annuity terminates and the remainder of the trust assets will vest in Taxpayer's children. The period of the annuity is ten years and the AFR rate is 8 percent. Assume Taxpayer outlives the ten-year term of the annuity and passes away thereafter. What are the tax consequences of Taxpayer's transfer to the trust?

Where \$1,000,000 is contributed to a GRAT in return for a retained annuity interest with an annual payment of \$50,000 and remainder to children, there has been a split interest gift. In order for Taxpayer to determine the amount of gift tax due, if any, he must first determine the value of the remainder interest given to each of his three children. Because the annuity is a fixed amount payable only to Taxpayer and the annuity must be paid annually, it is a "qualified" annuity under the regulations. Taxpayer is allowed to reduce the \$1,000,000 initial value of assets contributed to the GRAT by the value of Taxpayer's retained annuity interest.⁶⁷ To determine the value of Taxpayer's retained interest, Taxpayer must look up and apply the correct Table B annuity factor for a \$50,000 annual annuity payment over ten years at an AFR rate of eight percent. In this case it is calculated as follows:

- $\text{Payment} \times \text{Annuity Factor} = \text{Retained annuity interest}$
- $\$50,000 \times 6.7101 = \text{Retained annuity interest}$
- $\$335,505 = \text{Retained annuity interest}$
- $\text{Value of remainder} = \text{Fair market value asset} - \text{Retained annuity interest}$
- $\text{Value of remainder} = \$1,000,000 - \$335,505$
- $\text{Value of remainder} = \$664,495$

⁶⁷ I.R.C. §§ 2702(a)(2)(B); 7520.

The import of the above calculation is that Taxpayer has made a \$664,495 taxable gift to his three children. Dividing the gift by three results in a \$221,498 taxable gift to each child. It is important to note that the \$335,505 present value of the retained annuity interest plus any appreciation on the annuity amounts received would remain in Taxpayer's possession over the ten-year term of the GRAT and, unless otherwise spent, be included in Taxpayer's estate. At the expense of making a taxable gift, Taxpayer has removed \$664,495 of assets from his estate. If the stock appreciates at the assumed rate of eight percent, the future value of the \$664,495 will be \$1,434,595. Thus, the trust will have \$1,434,595 to distribute equally to the three children when the trust terminates ten years from the date of creation.

Continuing with some additional analysis, if the **actual** rate of appreciation of the stock is fifteen percent per year as predicted in the facts, the \$664,495 value of the remainder interest gifted would have a future value after ten years of \$2,688,253. At a fifteen percent rate of appreciation, the trust will have \$2,688,253 (as opposed to \$1,434,595 at 8 percent appreciation) to distribute equally to the three children after ten years. So, \$1,253,658 ($\$2,688,253 - \$1,434,595$) of additional appreciation will be available for distribution to the beneficiaries upon expiration of the GRAT term. Under this scenario, Taxpayer does not have to pay any additional gift taxes on the appreciation and he will have been able to give a tax-free gift of \$1,253,658 to his children.

Under these circumstances, from a gift tax perspective, a GRAT is a great estate planning tool to use because its stock is expected to appreciate over time at higher rate (15 percent per year) than the AFR (8 percent). By contributing the stock to a GRAT, Taxpayer has an opportunity to transfer the stock to his children and calculate his retained annuity interest at an assumed eight percent AFR rate (as opposed to the predicted fifteen percent). Because Taxpayer is allowed to calculate the value of the remainder gift under an assumed appreciation rate of 8 percent, Taxpayer may avoid paying gift or estate tax on any appreciation of the stock over and above the 8 percent rate under the IRS tables. Where the taxpayer has information that indicates that the asset will appreciate at a rate in excess of the AFR rate, the rules allow a windfall to the taxpayer in amount equal to the difference.

IV. GRAT PLANNING

Application of the above tax consequences pertaining to the taxation of GRATs might have an initial appearance of fairness in application. However, the existing statutory and newly amended regulations appear not

to address the possible imbalances that may arise in relation to current methods using GRATs in estate planning. This section describes the tax consequences of zeroed-out GRATs and then attempts to highlight the manner in which taxpayers are using zeroed-out GRATs to their great advantage.

A. Zeroed-Out GRATs

A “zeroed out” GRAT is an estate planning technique wherein there is no gift tax incurred on formation of a GRAT.⁶⁸ This is due to the fact that the grantor’s retained annuity payment is calculated in a fashion that results in no value being assigned to the remainder interest and, therefore, no gift tax due. The annuity payment is structured such that the present value of the retained annuity interest is equal to the full present fair market value of the property contributed to the GRAT.⁶⁹ This effectively results in no value being assigned to the remainder interest at the end of the GRAT term.

B. Walton v. Commissioner

Prior to the Tax Court’s holding in *Walton v. Commissioner*,⁷⁰ if upon creation of a GRAT the grantor’s estate retained the right to payments after his death, the IRS treated the right to receive such payments as a contingent interest.⁷¹ In Technical Advice Memorandum (TAM) 9707001, the IRS advised that such a contingent interest is not a qualified interest under I.R.C. § 2702(a) and, therefore, has no value.⁷² Because the retained interest is deemed to have no value, all of the value of the assets is assigned to the remainder interest, thereby subjecting the full fair market value of assets to gift tax.

In support of this conclusion, the IRS relied on example five of Treas. Reg. § 25.2702-3(e), which proposed the following fact pattern. Grantor A transfers property to a GRAT and retains the right to receive 5 percent of the net fair market value of the trust property for a term of ten years.⁷³ If A

⁶⁸ HENKEL, *supra* note 42, ¶ 22.05[3].

⁶⁹ *Id.*

⁷⁰ 115 T.C. 589 (2000).

⁷¹ I.R.S. Tech. Adv. Mem. 9707001 (Oct. 25, 1996).

⁷² *Id.*

⁷³ *Id.* (citing Treas. Reg. § 25.2702-3(e) (as amended in 1995))

dies within the ten-year term, the retained annuity interest does not terminate.⁷⁴ Rather, it is to be paid to A's estate for the balance of the ten year term.⁷⁵ Because the balance can be paid to A's estate, the example concludes that A's interest is not a qualified interest under I.R.C. § 2702.⁷⁶ The TAM reasons that A's interest may only be qualified if A's right to receive the payment is for "[ten] years or until A's prior death."⁷⁷ For purposes of § 2702(b), the right of the grantor's estate or another to receive the balance of the annuity payments combined with the possibility that a grantor could die during the GRAT term resulted in the grantor having a nonqualified contingent interest in the GRAT.⁷⁸

A further consequence of the outcome in TAM 9707001 and example five was that the value of the grantor's retained annuity interest would always be adjusted for the contingency that he or she might die within the term. Because there is a possibility that a grantor may die within the term, the value of the retained annuity must be reduced under the theory that the grantor may not receive all of the annuity payments. Correspondingly, if the value of the retained interest is reduced, the remainder interest in the same GRAT must always have at least some small positive value. Thus, said the IRS, a taxpayer may never "zero out" the value of the remainder interest in a GRAT.⁷⁹

However, the Tax Court addressed the contingent interest issue in its opinion in *Walton v. Commissioner*⁸⁰ and took a different approach than the IRS in TAM 9707001 and the outcome under example five of Treas. Reg. § 25.2702-3(e). In *Walton*, the taxpayer created two GRATs.⁸¹ Each GRAT had a term of two years and was funded with shares of stock.⁸² The annuity payments were structured such that the assets of each GRAT were exhausted upon the final payment of stock.⁸³ The taxpayer timely filed a gift tax return reporting the value of her retained interests in the GRAT's

⁷⁴ *Id.* (citing Treas. Reg. § 25.2702-3(e)).

⁷⁵ *Id.* (citing Treas. Reg. § 25.2702-3(e)).

⁷⁶ *Id.* (citing Treas. Reg. § 25.2702-3(e)).

⁷⁷ *Id.* (citing Treas. Reg. § 25.2702-3(e)).

⁷⁸ *Id.*

⁷⁹ HENKEL, *supra* note 42, ¶ 22.05[3].

⁸⁰ 115 T.C. 589 (2000).

⁸¹ *Id.* at 590.

⁸² *Id.*

⁸³ *Id.* at 591.

equal to 100 percent of the value of the stock on the date of the transfer.⁸⁴ By assigning all the value to the retained interest, no taxable gift would be left to the remainder persons and no gift was reported by the taxpayer.⁸⁵ The Commissioner issued a notice of deficiency determining that the taxpayer had understated the value of the gifts resulting from her establishment of the two GRAT's.⁸⁶ The sole issue for the Tax Court was the valuation of the gifts under I.R.C. § 2702.⁸⁷

The Tax Court found that notwithstanding the grantor could have died within the two-year GRAT term, taxpayer retained all interests in the two-year term annuities.⁸⁸ The Tax Court "construe[d] each of the subject GRAT's as creating a single, **noncontingent** annuity interest payable for a specified term of years to the . . . petitioner or her estate."⁸⁹ Further, the Tax Court held that the IRS's position was an unreasonable interpretation of I.R.C. § 2702.⁹⁰

Ultimately, the IRS gave in and acquiesced to the holding in *Walton*.⁹¹ The IRS has since issued regulations which apply to trusts created after July 2004 clarifying the treatment of a GRAT.⁹² At this point under the regulations it is possible for a grantor's estate to receive the remaining annuity payments if the grantor dies within the annuity term without creating a contingent interest.⁹³

C. Gift Tax Consequences of a Zeroed-Out GRAT

Again, assume Taxpayer owns all of the equity of a closely held family entity. The basis of the shares is \$10,000 and the value is \$1,000,000. The value of Taxpayer's shares is expected to increase at fifteen percent per year. Taxpayer is married to Wife, and they have three adult children. Assume Taxpayer contributes all \$1,000,000 of equity to a GRAT. The

⁸⁴ *Id.* at 591–92.

⁸⁵ *Id.* at 592.

⁸⁶ *Id.*

⁸⁷ *Id.* at 590.

⁸⁸ *Id.* at 595–96.

⁸⁹ *Id.* at 603.

⁹⁰ *Id.* at 604.

⁹¹ I.R.S. Notice 2003-72, 2003-2 C.B. 964.

⁹² Treas. Reg. § 25.2702-7 (as amended in 2005).

⁹³ See HENKEL, *supra* note 42, ¶ 22.05[2] (containing an excellent discussion of the *Walton* case and the demise of example five in Treas. Reg. § 25.2702-3(e)).

GRAT provides that if Taxpayer dies prior to the expiration of the annuity term, the remaining annuity payments will be paid to Taxpayer's estate. The term of the annuity is two years and the AFR rate is eight percent.

Under these circumstances, again, a GRAT would be an effective estate planning tool because the asset that Dad owns is an asset that is expected to appreciate at a rate that exceeds the AFR rate over time. The 15% expected return is greater than the AFR of 8 percent. This means that if the equity is contributed to a GRAT, Taxpayer can give his children a tax-free gift of the appreciation, if any, over and above the AFR rate. An example of a zeroed-out GRAT can be seen as follows.

If Taxpayer contributes the \$1,000,000 of stock to a new GRAT with a two-year term at an AFR rate of eight percent, the value of the remainder interest will be zero. Since the annuity is paid for a term of two years at a rate of eight percent, the annuity payments would be \$560,758 per year.⁹⁴ To illustrate how to calculate the retained annuity interest, the annuity payment value must be multiplied by the annuity factor, which is 1.7833 (from Table B two-year annuity) in this case.

- Payment \times Annuity Factor = Retained annuity interest
- \$560,758 \times 1.7833 = Retained annuity interest
- \$1,000,000 = Retained annuity interest
- Remainder gift = FMV of asset – Retained annuity interest
- Remainder gift = \$1,000,000 – \$1,000,000
- **Remainder gift = (\$0) . . . no gift or gift tax**

The import of the above calculation is that upon contribution of the stock to the GRAT, Taxpayer has made no taxable gift to his three children. Unfortunately, however, the \$1,000,000 present value of the

⁹⁴ This amount can also be arrived at by dividing the \$1,000,000 fair market value of the property contributed by 1.7833, the Table B Annuity factor for two years at an eight percent AFR.

retained annuity interest plus 8 percent appreciation on the annuity amounts received comes back into Taxpayer's possession over the two-year term of the GRAT. Because at an eight percent AFR rate it is **projected** that there will be nothing left in the GRAT at the end of the two-year annuity term, the remainder interest is deemed to be worth nothing. If indeed the stock **actually** appreciates at the assumed rate of eight percent, there will be nothing left in the GRAT to distribute at the end of the term.

If instead the actual rate of appreciation of the stock is fifteen percent per year as predicted in the facts, there would be excess appreciation left in the trust at the end of the two-year term. Thus, notwithstanding that the stock actually appreciates fifteen percent, the annuity payment would remain at \$560,758. At a fifteen percent rate of appreciation, the GRAT would produce \$1,230,012 (as opposed to \$1,121,516 at eight percent appreciation) over two years. So, \$108,496 (\$1,230,012 – \$1,121,516) of additional appreciation will be available for distribution to the beneficiaries upon expiration of the two-year GRAT term.⁹⁵ Under this scenario, Taxpayer does not have to pay any additional gift taxes on the appreciation and he will have been able to give a tax-free gift of \$108,496.

As a side note, it is also worth pointing out that if the closely held corporation goes public and the stock increases in value by say 500 percent, Taxpayer will avoid paying substantial gift taxes related to the excess of the 500 percent increase in value over the fifteen percent assumed rate of appreciation under the IRS actuarial tables.

D. Rolling Zeroed-Out GRATs

One of the drawbacks of the example in the previous section is that the zeroed-out GRAT only lasts for two years. At the end of the two-year term of the GRAT, except for the appreciation on the stock, Taxpayer will have received back his initial contribution of stock plus stock representing the eight percent AFR appreciation. However, if the transaction is structured as a set of rolling or sequential GRATs, Taxpayer can continue to shelter any growth on the GRAT payments that come back to him by creating new GRATs with the annuity payments he receives.

⁹⁵ Note that the same amount can be arrived at alternatively by dividing the \$1,000,000 asset value by the fifteen percent annuity factor of 1.626 to arrive at an annuity payment of \$615,006. By subtracting the actual payment of \$560,758 from \$615,006, the annual difference of \$54,248 and over two years the aggregate difference is \$108,496.

*E. Identifying the Tax Consequences and Problems**1. Estate Tax Consequences Upon Early Termination—New Regulations*

With respect to the value of the assets held in the GRAT, no estate tax consequences are implicated where the grantor outlives the GRAT term. This is because the grantor no longer retains an interest in the GRAT assets.⁹⁶ However, if the grantor dies prematurely within the term of the GRAT, either some or all of the assets held in the GRAT must be included in the grantor's estate.

On July 11, 2008, the IRS published final regulations,⁹⁷ which provide guidance on the tax treatment of, among other things, the amount that is included in a grantor's gross estate if the grantor dies within the period of a trust in which the grantor retained an interest.⁹⁸ Trusts governed by the regulations include certain charitable remainder trusts and other trusts in which the grantor has retained an interest.⁹⁹ A GRAT falls within the scope of the final regulations.¹⁰⁰

The regulations provide: "The portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to provide the decedent's retained use or retained annuity . . ." ¹⁰¹ However, the portion of the trust's corpus includible in the decedent's gross estate cannot exceed the fair market

⁹⁶ See I.R.C. § 2036(a) (2006).

⁹⁷ T.D. 9414, 2008-2 C.B. 454.

⁹⁸ Prop. Treas. Reg. § 20.2036, 72 Fed. Reg. 31487, 31487 (June 7, 2007). Specifically, the proposed regulations provide guidance on the portion of a trust properly includible in a grantor's gross estate under § 2036 and § 2039 if the grantor retained the use of property in the trust or the right to an annuity from the trust for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death. *Id.*

⁹⁹ The regulations also cover certain charitable remainder trusts such as charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs) as well as other trusts such as grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs). See T.D. 9414, 2008-2 C.B. 454. They also govern various forms of grantor retained income trusts (GRITs), qualified personal residence trusts (QPRTs) and other personal residence trusts (PRTs). *Id.*

¹⁰⁰ See *id.*

¹⁰¹ Treas. Reg. § 20.2036-1(c)(2) (as amended in 2008).

value of the trust's corpus at the decedent's date of death.¹⁰² Thus, if the grantor of a GRAT dies within the term of the GRAT, the portion of the GRAT that is includible in the decedent's gross estate is that portion necessary to generate a return sufficient to provide the decedent's retained annuity payment.¹⁰³ Insofar as I.R.C. § 2039 also applies to the tax treatment of a GRAT, the final regulations provide that § 2036, rather than § 2039, will be applied in cases where there is overlap.¹⁰⁴ The final regulations also specifically amend Treas. Reg. § 20.2039-1 to provide that I.R.C. § 2039 generally shall not apply to, among other things, a GRAT.¹⁰⁵

With respect to GRATs, the final regulations provide the following example:

D transferred \$100,000 to a GRAT in which D's annuity is a qualified interest described in [§] 2702(b). The trust agreement provides for an annuity of \$12,000 per year to be paid to D for a term of ten years or until D's earlier death. The annuity amount is payable in twelve equal installments at the end of each month. At the expiration of the term of years or on D's earlier death, the remainder is to be distributed to D's child (C). D dies prior to the expiration of the ten-year term. On the date of D's death, the value of the trust assets is \$300,000 and the [§] 7520 interest rate is 6 percent. D's executor does not elect to use the alternate valuation date.

The amount of corpus with respect to which D retained the right to the income, and thus the amount includible in D's gross estate under [§] 2036, is that amount of corpus necessary to yield the annual annuity payment to D (without reducing or invading principal). In this case, the formula for determining the amount of corpus necessary to yield the annual annuity payment to D is: annual annuity (adjusted for monthly payments) / [§] 7520 interest rate = amount includible under [§] 2036.

¹⁰² *Id.*

¹⁰³ *Id.* (citing I.R.C. § 601.601(d)(2)(ii)(b) (2006)); *see also* Rev. Rul. 82-105, 1982-1 C.B. 133; Rev. Rul. 76-273, 1976-2 C.B. 268.

¹⁰⁴ T.D. 9414, 2008-2 C.B. 454.

¹⁰⁵ Treas. Reg. § 20.2039-1(e) (as amended in 2008).

The Table K adjustment factor for monthly annuity payments in this case is 1.0272. Thus, the amount of corpus necessary to yield the annual annuity is $(\$12,000 \times 1.0272) / .06 = \$205,440$. Therefore, \$205,440 is includible in D's gross estate under [§] 2036(a)(1). If, instead, the trust agreement had provided that the annuity was to be paid to D during D's life and to D's estate for the balance of the [ten]-year term if D died during that term, then the portion of trust corpus includible in D's gross estate would still be as calculated in this paragraph. It is not material whether payments are made to D's estate after D's death. Under the facts presented, [§] 2039 does not apply to include any amount in D's gross estate by reason of this retained annuity.¹⁰⁶

There are several interesting aspects to note from the above example. The example assumes that D originally transfers \$100,000 to the GRAT and that it is to pay \$12,000 per year for ten years. Death of the taxpayer within the term of the GRAT triggers the requirements of I.R.C. § 2036 where under the taxpayer must include in gross estate the value of any property over which the taxpayer retained possession or enjoyment of the property.¹⁰⁷ Pursuant to the example, the amount includible in the grantor's estate upon the death of the grantor within the term of the GRAT is not \$100,000, the original value of the assets upon contribution. Nor is the full \$300,000 current value of the assets held in the GRAT included in the grantor's gross estate. Rather, the amount included is the annuity payment divided by the AFR at the time of taxpayer's death, or \$205,440. This calculation determines the amount of trust principal needed to produce the annual annuity payment in perpetuity assuming a six percent interest rate. There is no connection between the actual value of the GRAT assets as of the date of contribution or date of death. Rather, the value is dependent only on the amount of the annual annuity payment and the AFR rate on the date of death.

¹⁰⁶ Treas. Reg. § 20.2036-1(c)(2)(iii)(ex. 2) (citing *id.* § 20.2039.1(e)).

¹⁰⁷ I.R.C. § 2036(a) (2006).

V. TAX ANOMALIES IN CURRENT GRAT STRUCTURING

A. *Apparent Deficiencies in the New Regulations*

The tax effectiveness of any GRAT is dependent to a certain extent on the consequences of the death of the grantor inside of the GRAT term. As discussed previously, the portion of the trust's principal that is "includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to provide the decedent's retained use or retained annuity."¹⁰⁸ Under what circumstances will there be an increased risk under the newly finalized regulations that additional estate tax will be paid upon the death of the grantor within the GRAT term? One might hypothesize that additional estate taxes would be imposed where the assets contributed to the GRAT had appreciated at a rate that outperformed the market. After all, the benefits of a GRAT generally are realized when the appreciation of the contributed assets exceeds the AFR rate upon contribution. Conversely, it might also make sense that less estate tax would be imposed where the assets contributed to the GRAT failed to appreciate at a rate higher than the AFR or, in fact, declined in value.

Returning to the example given in the new regulations and ignoring the Table K adjustment factor for simplicity, in order for a \$12,000 annuity payment to result in inclusion in gross estate of only the originally contributed \$100,000, there would have to be a much higher AFR of twelve percent (as opposed to six percent) upon the death of the taxpayer within the GRAT term.¹⁰⁹ The higher the prevailing interest rate on the date of death, the lower the amount that will be included in taxpayer's gross estate. The example in the new regulations assumes a six percent AFR rate throughout the period between creation of the GRAT and the death of the taxpayer. At a constant rate of six percent, it is notable that when D passes away inside the ten-year GRAT term, approximately twice the original \$100,000 must be included in taxpayer's gross estate.¹¹⁰ Thus, at 6 percent, the amount required to support a \$12,000 annual payment for life doubles to \$205,440. The lower the prevailing interest rates on the

¹⁰⁸ Treas. Reg. § 20.2036-1(c)(2) (as amended in 2008).

¹⁰⁹ Note that $\$12,000 / 12\%$ results in \$100,000 of value included under the reasoning of the example.

¹¹⁰ Again, ignoring the Table K compounding factor for simplicity, the amount included would be $\$12,000 / 6\% = \$200,000$.

date of death, the higher the amount that must be included if the taxpayer passes away during the term of the GRAT. At a reduced four percent AFR rate at the death of the grantor, a full \$300,000 value must be included in grantor's estate.¹¹¹

When analyzed, the valuation method required under the new regulations can under certain circumstances result in tax consequences that appear illogical given the goals of I.R.C. § 2036. For instance, the AFR rate set for June 2009 used in determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest was 2.8 percent.¹¹² This rate is historically low.¹¹³ Three years prior to June 2009, the AFR rate for determining the present value of an

¹¹¹ Again, ignoring the Table K compounding factor for simplicity, the amount included would be $\$12,000 / 4\% = \$300,000$.

¹¹² Rev. Rul. 2009-16, 2009-23 I.R.B. 1058. AFR rates are published monthly as Revenue Rulings by the IRS. The current AFR rates can generally be found on the IRS website. Internal Revenue Serv., Dep't of the Treasury, Index of Applicable Federal Rates (AFR) Rulings, <http://www.irs.gov/app/picklist/list/federalRates.html> (last visited Aug. 24, 2009).

¹¹³ For an historical compilation of the AFR rates from June 2006 to June 2009, see Financial Concepts, Inc., Applicable Federal Rates, <http://www.finconcepts.com/WhatsNew/Documents/AFR%20Rate%20History%20Thru%20June%202009.pdf> (last visited Aug. 24, 2009). The following chart depicts the sharp decline in the I.R.C. § 7520 AFR from June 2006 through May 2009:

Month & Year	I.R.C. § 7520 AFR	Month-Year	I.R.C. § 7520 AFR	Month & Year	I.R.C. § 7520 AFR
June 2006	6.00	June 2007	5.60	June 2008	3.80
July 2006	6.00	July 2007	6.00	July 2008	4.20
Aug. 2006	6.20	Aug. 2007	6.20	Aug. 2008	4.20
Sept. 2006	6.00	Sept. 2007	5.80	Sept. 2008	4.20
Oct. 2006	5.80	Oct. 2007	5.20	Oct. 2008	3.80
Nov. 2006	5.60	Nov. 2007	5.20	Nov. 2008	3.60
Dec. 2006	5.80	Dec. 2007	5.00	Dec. 2008	3.40
Jan. 2007	5.60	Jan. 2008	4.40	Jan. 2009	2.40
Feb. 2007	5.60	Feb. 2008	4.20	Feb. 2009	2.00
Mar. 2007	5.80	Mar. 2008	3.60	Mar. 2009	2.40
Apr. 2007	5.60	Apr. 2008	3.40	Apr. 2009	2.60
May 2007	5.60	May 2008	3.20	May 2009	2.40

annuity was 6.0 percent.¹¹⁴ Assume \$100,000 of publicly traded stock was contributed to a newly created GRAT in June 2006 with a three-year term. Further, like the example given in the new regulations, assume the annuity payment was \$12,000 annually and the grantor passed away in February 2009 (inside the GRAT term) when the value of the securities had increased to \$300,000. Upon contribution, the grantor projected that his or her stock would increase at a rate higher than six percent and, in fact, the value of the securities did increase.

The AFR as published by the IRS in June 2006 indicates that the average appreciation of assets was projected by the Treasury to be 6.0 percent. Because the grantor passed away within the term of the GRAT, the grantor's estate must calculate the value of the portion of the GRAT assets to be included in grantor's gross estate under I.R.C. § 2036. Under the new regulations, the value in these circumstances would be calculated upon grantor's death at the new much lower June 2009 AFR of 2.8 percent to be \$600,000 (much higher than the original \$100,000 contributed).¹¹⁵ However, the value to be included in gross estate is limited to \$300,000, the actual value of the assets as of the date of death.¹¹⁶

It can, therefore, be concluded that where the AFR rates fall substantially after creation of the GRAT, the grantor's estate is likely to be required to include much more than the value of the originally contributed assets or at least the total value of the assets held in the trust. It can also be concluded that the grantor avoids the downside risk of having to report the whole \$600,000 value that is calculated under the regulation. This outcome seems anomalous in that grantors of GRATs appear to be required to pay more tax because the AFR rate decreased instead of paying more tax because the actual value of the assets increased. It is at least interesting to further note that the present value of the grantor's interest in a \$12,000 annuity at a specified AFR rate and term mathematically should decline throughout the life of the GRAT. Stated otherwise, assuming the GRAT document stated a set annuity for a set term of years, as time passes the remaining annuity payments will continuously decrease in value.

¹¹⁴ *Id.*

¹¹⁵ Treas. Reg. § 20.2036-1(c)(1)(ii)(ex. 2) (as amended in 2008). Thus, in the first step, the regulation would require the value to be included in grantor's estate to be $\$12,000 / 2\% = \$600,000$.

¹¹⁶ *Id.* § 20.2036-1(c)(2)(i).

But, what happens when the AFR increases over time and is higher on the grantor's death? Assume again that \$100,000 of publicly traded stock was contributed to a newly created GRAT with a three-year term. However, this time assume that the GRAT was created in February 2009 when the AFR rate was two percent (instead of six percent). Again, the annuity payment is \$12,000 annually. Assume the grantor passed away in January 2012 and that the securities were again worth \$300,000 upon grantor's death. Assume that in January 2012, the AFR rate had increased to 8% when the grantor died inside the three-year term. Again, the grantor's estate must calculate the value of the portion of the trust corpus and, under the new regulations, the new amount that must be included is \$150,000 (rather than \$600,000).¹¹⁷ Under these circumstances, the grantor's estate escapes reporting the \$150,000 of extra value actually held in the trust as of the date of death.¹¹⁸ Instead of having to report the \$200,000 value of the assets upon death, only \$150,000 is required to be reported in gross income. Surprisingly, it appears here that where the AFR rates go up the grantor is rewarded. Again, the grantor's estate is allowed to escape tax on the excess appreciation. Why should grantors who create GRATs in declining interest rate environments be better situated than grantors who create GRATs in increasing interest rate environments? In the end, under both scenarios, the GRAT assets increased in value by the same amount.

Keeping in mind that one of the main policies behind I.R.C. § 2036 is to require that decedent's estate include in gross estate amounts over which they retained an interest, the outcome of the new regulations seems to miss its mark. Instead of requiring inclusion of the actual value of the assets held in the GRAT upon the grantor's death or measuring the value of the annuity actually retained by the grantor at his or her death, the IRS appears to be requiring inclusion of a fictitious amount of trust corpus equal to an amount that supports the same annuity payment at the new AFR rate upon grantor's death. This leads to a certain randomness that cannot be

¹¹⁷ Here the limitation in the regulations does not apply because the value as calculated under the formula is less than the actual value of the assets. *Id.* § 20.2036-1(c)(2). Thus, the regulation would require that $\$12,000 / 8\% = \$150,000$ be included in grantor's estate. *See id.* § 20.2036-1(c)(1)(ii)(ex. 2).

¹¹⁸ Note that the \$150,000 is the difference between the \$300,000 actual value at death and the \$150,000 value as determined under the new regulation.

accounted for by taxpayers who seek to form GRATs. Further, the randomness sometimes results in a windfall to the taxpayer and at other times merely captures the actual value of the assets in the trust. Moreover, under these circumstances, there is little downside risk to the taxpayer that he or she will have to pay tax based upon performance of the GRAT assets.

It would seem more logical under the policy of I.R.C. § 2036 that the value of the annuity as stated under the terms of the GRAT (using the original AFR rate) plus or minus some percentage of the increase or decrease in the value of the assets between the date that the GRAT was formed and the death of the grantor within the term. For example, assume that upon formation of the GRAT the grantor retained a 20% interest in the GRAT assets and was treated as having made a gift of the remaining 80% of the assets to the remainder person. Upon grantor's early death within the term of the GRAT, the grantor arguably should have to include the present value of the annuity payments that are as yet unpaid plus or minus 20% of the increase or decrease in the value of assets as of the time of grantor's death. In this fashion, the grantor retains the upside and downside risk in the market changes directly rather than leaving the calculation to be dependent upon the change in the AFR rate, which has no meaningful connection to the value of the assets contributed.

B. Zeroed-Out GRATs—An Effective Estate Freeze?

As discussed above, with the creation of zeroed-out rolling GRATs, taxpayers have found what amounts to a win-win scenario to avoid gift taxation. Using the two-year zeroed-out rolling GRAT effectively results in transferring any appreciation in the assets contributed to the GRAT beginning as of the date that the taxpayer engages in a sequence of rolling GRATs. As such, the two-year zeroed-out rolling GRAT allows taxpayers to effectively freeze the value of the GRAT assets for estate tax purposes. Each two-year period that the grantor outlives will result in the fair market value of the assets being returned to the grantor in the form of annuity payments with the excess appreciation being left in the GRAT. At the end of the GRAT, the excess appreciation amounts left in the trust may be distributed to family member remaindermen pursuant to the terms of the GRAT without any additional gift or estate tax consequence. Under this method, a grantor may effectively transfer any appreciation in the assets to his or her family member(s).

With the evolution of the zeroed-out GRAT, the estate planning profession seems to have once again frustrated the goals of the Treasury. Congressional efforts to thwart or prevent taxpayers from engaging in effective estate freezes are not a new concept. Between I.R.C. § 2036 and

Chapter 14 including I.R.C. §§ 2701 through 2703, Congress has attempted several times to prevent taxpayers from engaging in estate freezes specifically in relation to the use of trusts. However, by ingenious planning techniques, a taxpayer can minimize or avoid any risk of incurring gift taxes in relation to appreciating assets.

Returning again to the new regulations under I.R.C. § 2036, a grantor's estate must include in gross estate an amount equal to the portion of the GRAT assets, valued as of the date of the grantor's death, necessary to yield the annual annuity payment "without reducing or invading principal."¹¹⁹ Under this requirement, the IRS appears to take the position that the grantor's estate should include an amount that in effect would support the designated annuity payment forever. Indeed, the very nature of a zeroed-out GRAT contemplates that the principal or corpus of the GRAT will be exhausted at the end of the short term of the GRAT.

With respect to a zeroed-out GRAT, the methodology for valuation under the new (and old) regulations fails to address the bona fide sale exception to I.R.C. § 2036. A decedent's gross estate does not include the value of an interest that was transferred "for an adequate and full consideration in money or money's worth."¹²⁰ In the zeroed-out GRAT, the grantor transfers the assets into the GRAT in return for a stream of annuity payments that have a fair market value equal to the value of the assets contributed. The grantor has exchanged assets contributed to the GRAT for an annuity payment of equal value, and this exchange can be likened to a bona-fide exchange for fair market value.

This argument was submitted by commentators in response to the proposed new regulations.¹²¹ The Treasury acknowledged the argument but indicated that the adequate consideration exception or "bona fide sale" exception did not apply.¹²² The Treasury reasoned that in a bona fide sale, "[t]here is a negotiation and agreement between two parties, each of whom is the owner of the property interest before the sale," whereas in the creation of a GRAT, the transferor is not selling the property.¹²³ Further, the transferor in a GRAT "is transferring the property subject to a retained

¹¹⁹ T.D. 9414, 2008-2 C.B. 454; *see also* Treas. Reg. § 20.2036-1(c)(2).

¹²⁰ Treas. Reg. § 20.2036-1(a); *see also* I.R.C. § 2036(a) (2006).

¹²¹ T.D. 9414, 2008-2 C.B. 454.

¹²² *Id.*

¹²³ *Id.*

possession and enjoyment of, or right to, the income from the property.”¹²⁴ The Treasury pointed out that if the grantor retains an interest for life, “the property is subject to inclusion in grantor’s gross estate.”¹²⁵ However, these reasons forwarded by the Treasury do not acknowledge that when a grantor creates a GRAT, he or she does so for a term of years. The grantor is required to use the IRS provided actuarial tables and AFR to determine the value, if any, of the amount of any gift that is transferred for gift tax purposes. Indeed, the remainder interest has been transferred irrevocably.

The incompleteness of the Treasury’s reasoning is especially revealed in the area of zeroed-out GRATs. As previously explained, where a grantor creates a zeroed-out GRAT, there is no value assigned to taxable gift. This is because under the current AFR at the end of the term of the GRAT, there is no projected value to the remainder. Indeed, if the assets contributed to the GRAT appreciated at a rate equal to the AFR, there would be nothing in the GRAT after the last annuity payment is made to the grantor. However, if the assets held by the GRAT appreciate at a rate higher than the AFR, the remainder interest holder will receive an amount equal to the excess appreciation. Under these circumstances, where the grantor outlives the term of the GRAT, the transaction can be analogized to a bona-fide sale in that the grantor exchanged the GRAT assets for a right to an annuity of equal value. The transfer was irrevocable and for fair consideration.

It might have been reasonable for the Treasury to have acknowledged an exception and agreed that the creation of a zeroed-out GRAT fell into the bona-fide sale exception. Then, arguably, if the grantor passed away within the term of the GRAT, the grantor’s estate would not fall into the retained interest rules of I.R.C. § 2036. Instead, because the grantor’s estate has a right to the payments as consideration in a sale or exchange, the grantor’s estate would have to include in gross income the present value of the remaining annuity payments due to the grantor’s estate through the end of the term. Seemingly, this value would be most representative of the interest that was retained by the grantor.

¹²⁴ *Id.*

¹²⁵ *Id.*

C. Discounts on Assets (FLP, FLLC)

Another effective GRAT technique, which also appears to exceed the intended benefit of the regulations, includes the contribution of discounted business interests to a GRAT. For example, assume that the grantor of a GRAT holds a minority interest in a closely held C corporation, S corporation, limited liability company, or limited partnership. A minority interest in stock shares of a closely held corporation or units in a closely held LLC or LLP are typically subject to minority (lack of control) and marketability discounts.¹²⁶ Because of their discounted value, such assets are excellent prospects for contribution to a GRAT. This is because the grantor's gift tax consequences are based upon the reduced value of the discounted interests thereby reducing the value of the gift of the remainder interest. If the shares of stock or units of LLC or LP interests increase substantially in value during the GRAT term, the remainder interest may substantially exceed the appreciation assumed under the AFR. Based on the discussion thus far describing the low risk and high benefits of GRATs, it would appear that the tax benefits of contribution of assets that are already subject to minority and lack of marketability discounts to a GRAT are arguably even more lopsided in favor taxpayers.

Legislators are now focusing on such transactions with an eye toward limiting what they perceive to be excessive tax benefits. On January 7, 2009, a bill was introduced as proposed change in the law.¹²⁷ In general, H.R. 436 proposes to amend the Internal Revenue Code of 1986 to repeal new carryover basis rules and prevent tax increases that will come into effect in 2010 under the current law.¹²⁸ Among other things, the bill seeks to set the estate tax exemption equivalent at \$3,500,000;¹²⁹ freeze the maximum estate tax rate at forty-five percent;¹³⁰ and implement new restrictions on taxpayer's ability to benefit from minority interest valuation discounts on certain transfers of nonbusiness assets.¹³¹

Of importance to this article is the bill's attempt to restrict benefits obtained by using valuation discounts. Taxpayers have often sought to

¹²⁶ See HENKEL, *supra* note 42, ¶ 16.03[1].

¹²⁷ Certain Estate Tax Relief Act of 2009, H.R. 436, 111th Cong. (2009).

¹²⁸ *Id.*

¹²⁹ *Id.* § 3(a).

¹³⁰ *Id.* § 3(b).

¹³¹ *Id.* § 4.

reduce the value of assets for gift and estate tax purposes through use of minority interest discounts in a business or an undivided interest in property held by the taxpayer. In relation to business entities, the valuation rules under I.R.C. § 2031 support the notion that the fair market value a decedent's interest in a business, whether a partnership, or a proprietorship, is the amount which a willing purchaser would pay for the interest.¹³²

If a taxpayer owned 100 percent of a closely held entity which had a fair market value of \$1,000,000, the seller taxpayer would likely find a willing buyer to purchase all of seller's interest for that amount. However, with respect to a minority interest in the same entity, a willing purchaser would not pay seller a pro rata value for such a minority interest. Essentially, a minority discount is recognized because the holder of a minority interest has no control over the entity in which he holds an interest.¹³³

In an effort to curtail taxpayers' ability to obtain certain valuation discounts, H.R. 436 proposes to disallow minority discounts where nonbusiness assets are contributed to a business entity for the purpose of later obtaining a discount. The relevant proposed statutory language in section 4(d) of the bill is as follows:

In the case of the transfer of any interest in an entity . . . (A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and (B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.¹³⁴

For purposes of the rule, the term "nonbusiness asset" means any asset which is not used in the active conduct of a trade or business.¹³⁵ Such nonbusiness assets include, among other items, passive type assets such as

¹³² Treas. Reg. §§ 20.2031-1(b), -3 (as amended in 1992).

¹³³ See *Ward v. Comm'r*, 87 T.C. 78, 106 (1986).

¹³⁴ H.R. 436 § 4(d)(1)(A)–(B).

¹³⁵ *Id.* § 4(d)(2)(A). Exceptions also exist in the proposed legislation for assets used in the active conduct of a trade or business, real property used in trades or businesses, and certain types of working capital. *Id.* § 4(2)(B)–(C).

an annuity.¹³⁶ Thus, if a grantor of a GRAT formed a closely held family entity for the purpose of transferring various nonbusiness assets to the entity, and, thereafter, the grantor contributed a minority interest in the entity to a GRAT, the value of the minority interest would be determined as if the grantor had transferred the assets directly to the GRAT without the benefit of a valuation discount. Further, if an annuity is transferred to a closely held entity and the taxpayer attempts to transfer any interest in such entity, the value of the annuity must be determined as if the transferor had transferred the annuity directly to the transferee without a valuation discount. No benefit from valuation discounts may be derived by taxpayers who contribute an annuity to a closely held entity in order to gift minority interests to family members.

H.R. 436 also contains a broader restriction in section 4(e) eliminating any discounts for lack of control. This provision provides:

For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity . . . no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family . . . of the transferee have control of such entity.¹³⁷

Under the language of the proposed bill, with respect to contribution of a minority interest in a family entity to a GRAT, no discount in value would benefit the grantor on contribution of the minority interest to the transferee GRAT. The ordinary tax benefits of the GRAT would continue to be enjoyed but taxpayer grantors would not get the double benefit of both a valuation discount and the benefit of using the published actuarial

¹³⁶ *Id.* § 4(d)(3)(E). A complete list of the passive assets specified in section 4(d)(3) of the bill are as follows: (A) cash or cash equivalents; (B) stock in a corporation or any other equity, profits, or capital interest in any entity; (C) evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative; (D) asset described in clause (iii), (iv), or (v) of section 351(e)(1)(B); (E) annuity; (F) real property used in one or more real property trades or businesses (as defined in section 469(c)(7)(C)); (G) asset (other than a patent, trademark, or copyright) which produces royalty income; (H) commodity; (I) collectible (within the meaning of section 401(m)); or (J) any other asset specified in regulations prescribed by the Secretary. *Id.* § 4(d)(3)(A)–(J).

¹³⁷ *Id.* § 4(e).

tables for determining the value of the grantors retained interest and the remainder interest to the third party.

The proposed legislation, if it becomes law, also has sweeping consequences in relation to valuation of interests in closely held entities. In general, the proposed legislation prohibits use of common discounts in the valuation of closely held family entities. The issue of whether it is appropriate to restrict or prohibit all such discounts is beyond the scope of this discussion. However, at least in relation to taxation of GRATs, it is arguably appropriate for the Treasury to prohibit such discounts in an effort to limit these additional benefits that a taxpayer may obtain in setting up a GRAT.

D. Additional Anomalies in the Area of Private Annuities

In general, a private annuity begins with a transfer of property from one person (the “Seller”) to another (the “Buyer”) in exchange for a promise to make periodic annuity payments.¹³⁸ The annuity payments are generally made for the Seller’s lifespan.¹³⁹ Where the Seller’s lifespan defines the term, the estimated lifespan is determined by reference to the government-published actuarial tables.¹⁴⁰ In *Estate of Hurford*, the Tax Court characterized the purpose of a private annuity as follows:

[T]he value of the periodic-payment stream equals the value of the transferred property, so the private annuity removes the transferred property from the transferor’s estate and gives the transferee any appreciation in the transferred property’s value. The usually unspoken usefulness of this device is greatest when those arranging

¹³⁸ See *Estate of Hurford v. Comm’r*, 96 T.C.M. (CCH) 422, 427 (2008).

¹³⁹ *Id.*

¹⁴⁰ *Id.* Note that in a commercial annuity setting, the purchaser of the annuity pays premiums to an insurance company and the insurance company agrees in return make annuity payments to the purchaser. The purchaser is referred to as the “annuitant” but the annuitant can also be any third party (e.g., not the purchaser). For example, where the term of the annuity is for the life of the annuitant, the insurance company agrees to make the annuity payment beginning on an agreed upon date and will continue to pay throughout the annuitant’s life. The premium paid by the purchaser will vary with, among other things, the annuitant’s age. The longer the estimated life expectancy, the longer will the projected payout and the higher the resulting premium payment.

it know more about the particulars of their situation than is reflected in the actuarial tables or—to be blunt—when children think their parent won't survive for very long.¹⁴¹

It is important to note that where the Seller's life expectancy is too short due to a terminal illness, the regulations prevent taxpayers from using the actuarial tables.¹⁴² In this regard, the regulations provide that a "physical condition is considered terminally ill if there is at least a 50 percent chance that the individual will die within [one] year."¹⁴³ Where the life expectancy of the Seller annuitant is more probably than not less than one year, the parties to the private annuity may not use the published IRS mortality tables. Rather, the parties must use the Seller annuitant's projected life expectancy (e.g., a shorter life expectancy) to calculate the annuity payments.¹⁴⁴

Where the annuitant's life expectancy is longer than a year, a private annuity can be an effective tool for removing property from the seller's estate.¹⁴⁵ Assume that Dad is wealthy and he seeks to remove property with a fair market value of \$10,000,000 from his estate. Assume further that Dad is suffering from lung cancer and has a fifty percent or better chance that his life expectancy is two to three years. Dad should be able to substantially minimize gift and estate tax consequences as a result of using a private annuity.¹⁴⁶ Rather than using Dad's life expectancy of two to three years due to his terminal cancer, the I.R.C. § 7520 actuarial tables can be used to value the annuity to be paid to Dad for his projected life (e.g., as if he were healthy). If the actuarial value or present value of the stream of annuity payments to Dad equals the fair market value of the property, then there is no gift. For instance, if the total amount of the

¹⁴¹ *Id.*

¹⁴² *Id.*; see also Treas. Reg. § 20.7520-3(b)(3)(i) (as amended in 1995).

¹⁴³ See Treas. Reg. § 1.7520-3(b)(3) (as amended in 1995).

¹⁴⁴ See *id.* § 1.7520-3(b)(4)(ex. 2).

¹⁴⁵ It should be noted that the benefits of a private annuity have been minimized by proposed regulations issued in 2006, which require that seller recognize immediate gain on an annuity transaction rather than any gain being reported ratably over the life expectancy of the seller. Prop. Treas. Reg. § 1.1001-1(j)(1), 71 Fed. Reg. 61441, 61444 (Oct. 18, 2006).

¹⁴⁶ Of course there are also income tax consequences to private annuities which discussion is beyond the scope of this article.

annuity payments (based upon Dad's life expectancy without cancer) made from Son to father has a present fair market value of \$10,000,000 and the property transferred by Dad has a fair market value of \$10,000,000, there will be no gift tax consequences.¹⁴⁷ Rather it will be considered a sale for adequate and full consideration.¹⁴⁸

Under these circumstances, if Dad's I.R.C. § 7520 actuarial life expectancy is twenty years, then each annual payment will be less than if the annuity was calculated for a period of two or three years. If Dad transfers his interest in the family business to Son in exchange for the Son paying an annuity of \$871,847¹⁴⁹ per year for the rest of Dad's projected life and father dies after three years, son will have made payments of \$2,615,541.¹⁵⁰ This outcome allows the son to obtain a \$10,000,000 asset for \$2,615,541. Dad will have made a transfer-tax-free gift of \$7,384,458 (\$10,000,000 less \$2,615,541).¹⁵¹ Remarkably, under this scenario, father has avoided substantial gift and estate tax by an extremely advantageous use of the I.R.C. § 7520 actuarial tables. In truth, because father had information that indicated that he would not in fact live as many years as is projected under the actuarial tables for a healthy person, father has engaged in a fictional calculation that creates a large gift tax windfall by engaging in the annuity.

Such windfalls should not be available where taxpayers have inside knowledge and choose to engage in a transaction solely in order to reduce gift or estate tax consequences. The Treasury could minimize such transactions in at least two ways. First, the definition of terminally ill

¹⁴⁷ See Treas. Reg. § 25.2512-8 (as amended in 1992).

¹⁴⁸ *Id.* Again, this transaction may result in gain for income tax purposes and a capital gain may result.

¹⁴⁹ Note that such an annuity payment would result if, for example, Dad had a twenty-year life expectancy and the AFR rate was 6.0%. Under such circumstances, the annuity factor would be 12.3766 which when multiplied by the payment amount of \$871,847.18 results in an annuity with a present value of \$10,000,000. See, e.g., Treas. Reg. § 20.2031-7 (as amended in 2000) (referring to actuarial Table B, Annuity, Income and Remainder Interests for a Term Certain).

¹⁵⁰ The \$2,615,541 is arrived at by multiplying the annuity payment of \$871,847 by three years.

¹⁵¹ Again, it should be noted that per the Treasury Regulations, the actuarial tables cannot be used if "there is at least a 50 percent probability that the individual will die within [one] year." See Treas. Reg. § 1.7520-3(b)(3) (as amended in 1995).

could be amended to require at least a fifty percent chance that the individual will die within three years. Such an amendment would prevent taxpayers from benefiting from diseases that are terminal in less than three years. Alternatively, the Treasury could reserve the right for a period of years to revalue the stream of annuity payments if the annuitant passes away within such period of years. Thus, for example, if the annuitant passed away within five years of creating the annuity, the Treasury may reserve the right to challenge the value of the consideration exchanged. If the payments over the five years do not equal the value of the asset, the Treasury may then impose additional gift or estate tax. Other methods may also be fair to impose, but continuing to let taxpayers create private annuities that avoid such substantial amounts of tax seems inappropriate.

VI. CONCLUSION

GRATs and private annuities are excellent instruments that can result in substantial gift and estate tax savings if used in the right set of circumstances. Taxpayer's would be well advised to take advantage of such instruments in planning for the devolution of their assets during life and upon death.

However, these instruments in certain instances appear to have evolved into transactions that provide taxpayers with substantial tax savings. In the common setting, a taxpayer will only implement a GRAT or private annuity when the taxpayer has information that indicates that the transaction will likely result in favorable tax benefits. In the case of a GRAT, the taxpayer will form a GRAT when information indicates that the assets will appreciate at a rate higher than the average forecasted rate of appreciation published in the AFRs by the IRS. If the assets appreciate faster than the rate projected by the current AFR, the taxpayer will realize substantial tax savings. If, on the other hand, the assets appreciate at a rate lower than the AFR, the taxpayer will generally only have to include at most the value of the assets remaining in the GRAT as of the date of death. Depending on the AFR rate at death, a taxpayer may sometimes have to include the assets at a value that is less than the value of the remaining assets as of the date of death.

In the case of a private annuity, a taxpayer will generally engage in the transaction if the annuitant has a projected lifespan that is less than his or her actuarial lifespan as determined under the IRS actuarial tables. Often this is the case when annuitant is terminally ill. No gift will exist and no gift tax will incur when the annuity is engaged in. But, when the annuitant passes away, the seller of the annuity is relieved of any further annuity payments. In effect, the seller receives a large gift at very little gift tax

cost. Where the annuitant is relatively young and has a substantial lifespan under the actuarial tables, a large taxpayer windfall can occur. Although the courts have not targeted such transactions as shams or lacking in economic substance, it would appear that GRATs and private annuities more likely result in substantial tax savings with little if any risk of an increased tax burden.

Legislators now appear to be focusing on certain aspects of such annuity transactions. The Treasury has done very little to this point in time in the way of acknowledging the lopsided nature of the benefits to taxpayers and, if anything, has allowed to taxpayers to continue to engage in such transactions without imposing any limits. Taxpayers appear to be receiving favorable tax treatment by engaging inventive and creative counsel to structure their financial holdings. It would seem reasonable that the Treasury begin to focus on such transactions and promulgate regulations that would bring the risk and reward of such transactions back to more of an even balance between taxpayers and the Treasury.